RB-2008-02 Guidance on Allowance for Loan and Lease Losses

October 22, 2008

Allowance for Loan and Lease Losses

PURPOSE

This Bulletin updates the guidance on the Allowance for Loan and Lease Losses (ALLL) for state chartered credit unions originally issued by the Department in May 2000 (Regulatory Bulletin 2000-1). The information is primarily intended to reiterate key concepts and requirements included in Generally Accepted Accounting Principles (GAAP) and existing federal supervisory guidance. Detailed information on acceptable ALLL methodologies and related issues that apply to all federally-insured credit unions is available in the following supervisory statements issued by the National Credit Union Administration:

- NCUA Accounting Bulletin 09-01, Interagency Policy Statement on the Allowance for Loan and Lease Losses (ALLL) – December 2006
- NCUA Letter to Credit Unions 02-CU-09 NCUA Interpretive Ruling and Policy Statement No. 02-3, Allowance for Loan and Lease Losses (ALLL) Methodologies and Documentation for Federally-Insured Credit Unions — June 2002

BACKGROUND

The ALLL is a valuation reserve established to recognize estimated loan impairment. The reserve is an accounting estimate of probable but unconfirmed asset impairment that has occurred in the loan portfolio as of the financial statement date. The determination of an appropriate ALLL level must be based on management's judgments about the credit quality of the loan portfolio and other relevant internal and external factors that affect loan collectability. A credit union that fails to maintain an adequate ALLL balance or related operating procedures will be considered to be operating in an unsafe and unsound manner.

REGULATORY STANDARD

Section 91.718(c) of the Rules of the Credit Union Commission details minimum regulatory standards for full and fair disclosure of the estimated loan losses. The rule specifies that the board of directors is responsible for ensuring controls are in place to consistently determine the ALLL in accordance with its written policies, GAAP, and relevant supervisory guidance. Each credit union is also required to develop, maintain, and document the methodology used to determine the appropriate ALLL and related loan loss expense. The rule further provides that adjustments to the ALLL must be made prior to the end of each calendar quarter to accurately reflect the loss exposure on the quarterly call report.

RESPONSIBILITIES OF THE BOARD OF DIRECTORS AND MANAGEMENT

To ensure compliance with the regulatory standard, each credit union's board of directors must establish a written policy that addresses the procedures for evaluating the adequacy of the ALLL. The policy must be consistent with the size of the credit union and the nature and risk of its lending

activities. Minimum policy requirements for all financial institutions are addressed in more detail in the Interagency Policy Statement on the Allowance for Loan and Lease Losses issued jointly by the federal financial regulatory agencies in December 2006. At a minimum, each credit union's ALLL policy must ensure that:

- The process for determining an appropriate level for the ALLL is based on a comprehensive, welldocumented, and consistently applied analysis of the loan portfolio.
- There is an effective loan review system and controls that identify, monitor, and address asset quality problems in an accurate and timely manner.
- There are adequate data capture and reporting systems to supply the information necessary to support and document its estimate of an appropriate ALLL.
- Loss estimation models are periodically evaluated to ensure that the resulting loss estimates are consistent with GAAP.
- Loans are promptly charged-off when available information confirms them to be uncollectible.
- The ALLL methodology is periodically reviewed and validated.

The board policy will serve as the basis for management to adjust the ALLL due to changes in the loss exposure from the loan portfolio. However, the credit union's board of directors remains responsible for overseeing management's assessment of the ALLL balance. At a minimum, the board's oversight must include:

- Reviewing and approving the institution's writtenALLL policies and procedures at least annually.
- Reviewing management's assessment and justification that the loan review system is sound and appropriate for the size and complexity of the

credit union

- Reviewing management's assessment and justification for the amounts estimated and reported each period for the ALLL and related loan loss expense.
- Requiring management to periodically validate and, when appropriate, revise the ALLL methodology.

METHODOLGY

he ALLL methodology is the system a credit union uses to reasonably estimate loan losses as of the financial statement date. Since no single method is deemed to be best, or appropriate for all credit unions, the Department does not require credit unions to use one specific methodology. However, each credit union must ensure that a comprehensive methodology is in place that satisfies the requirements of GAAP. The primary accounting standards for assessing loan loss exposure are detailed in Financial Accounting Standards No. 5 and 114 as discussed below. Financial Accounting Standard No. 5, Accounting for Contingencies (FAS 5) is the most common method used to estimate the loss exposure in a credit union's loan portfolio. The guidance specifies that the loss on a loan be recognized when it is probable and can be reasonably estimated. Per FAS 5 guidelines, loans with like risk characteristics are pooled and a loss factor applied to the pool based on the historical loss rate for the loan type. The loss factor is normally based on the historical experience during the past 12-36 months. The loss factor(s) may be updated for recent changes in underwriting standards, staff experience, credit concentration, business conditions, and economic trends.

Small, less complex credit unions may elect to determine an appropriate level for the ALLL by simply segmenting the loan portfolio into secured consumer loans, unsecured consumer loans, and real estate loans. Larger, more complex

institutions should have the ability to pool loans by grade (A, B, C or D paper) or other unique risk factors for each loan type.

Financial Accounting Standard No. 114 Accounting for Contingencies for Impairment of a Loan involves a review of individual loans that are impaired. This loss estimate method is generally used for larger or non-homogenous loans. The loss estimate for each loan must be based on the present value of expected future cash flows, fair value of collateral less costs to sell, or the loan's observable market price. Individually reviewed loans that are determined not to be impaired under FAS 114 should be grouped with other loans that share similar risk characteristics and evaluated for impairment under FAS 5. Credit unions must avoid double counting the estimated loss on impaired loans by including them in both the FAS 114 and FAS 5 calculations.

EXAMINER RESPONSIBILITIES

Examiners will complete a review of the credit union's ALLL policy, methodology, and controls to determine compliance with supervisory guidance, GAAP, and Commission Rule 91.718. Specific steps that will be completed during the examination process include:

- Review the adequacy of the credit union's policy in relation to the size and complexity of the credit union.
- Determine whether the board of directors reviews and approves the policy and methodology at least annually.
- Determine whether the policy and procedures are consistent with GAAP and other supervisory guidance.
- Assess the adequacy of the supporting documentation for the ALLL methodology and calculations.
- Determine whether the ALLL provides a reasonable estimate of the loss exposure from the loan portfolio.